United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-2001

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In The

United States Court of Appeals

For The Second Circuit

L. JOHN JACOBI and ROBERT GAMBERA, individually, on behalf of the members of the AMERICAN ASSOCIATION OF SECURITIES REPRESENTATIVES, and on behalf of all other securities representatives similarly situated,

Plaintiffs-Appellants,

vs.

BACHE & CO., INC.; WALSTON & CO., INC; THOMSON & McKINNON AUCHINCLOSS, INC. (formerly THOMSON & McKINNON, INC.); HORNBLOWER-WEEKS, HEMPHILL, NOYES; LOEB, RHOADES & COMPANY; TUCKER, ANTHONY & R. L. DAY; HARRIS, UPHAM & CO., INC; DOMINICK INT'L. CORP.; HALLE & STIEGLITZ, INC.; GOODBODY & CO.; BEAR, STEARNS & CO.; LEHMAN BROS.; KIDDER PEABODY & CO., INC.; R. W. PRESSPRICH & CO., INC.; DEAN WITTER & CO., INC.; W. E. HUTTON; REYNOLDS & CO.; PAINE, WEBBER, JACKSON & CURTIS; SCHEINMAN, HOCKSTIN & TROTTA, INC.; PRESSMAN FROLICH & FROST, INC.; NEWBURGER, LOEB & CO.; RAUSCHER, PIERCE SECURITIES CORP.; OPPENHEIMER & CO.; STEINER ROUSE & CO., INC.; L. F. ROTHSCHILD & CO.; SPENCER TRASK & CO.; SMITH BARNEY & CO., INC.; and THE NEW YORK STOCK EXCHANGE, INC.,

Defendants-Respondents

UNITED STATES COURT OF APPEALS FILED NOV 13 1974 SECOND CIRCUIT

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REPLY BRIEF FOR PLAINTIFFS-APPELLANTS

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INDEX TO REPLY BRIEF

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REPLY BRIEF ON BEHALF OF PLAINTIFFS-APPELLANTS

I. APPELLEES BY THEIR SILENCE HAVE CONCEDED THAT THE RULE PROHIBITING PAYMENT OF COMMISSIONS BASED ON THE SERVICE CHARGE WAS A PRICE FIXING SCHEME

The key, indeed crucial, nolding of the court below

was that the rule prohibiting the payment of commission based on the service charge was not a price fixing scheme because it was not price fixing "on its face" (432A - 434A). For this reason, Point I of plaintiffs-appellants' original brief is directed exclusively towards attacking this holding, and to setting forth the authorities which establish that "any combination which tampers with price structures" is a per se violation of the antitrust laws (absent some basis for antitrust immunity), see United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 221, 60 S. Ct. 811, 843 (1940). In these circumstances, it is significant that in neither of the two briefs filed on behalf of appellees is any attempt made to contest appellants' argument that the rule prohibiting payment of commission based on the service charge was such a price fixing scheme and therefore a per se violation of the antitrust laws absent some basis for antitrust immunity.

Appellees, in their briefs, studiously avoid discussing this question, and they make no attempt whatsoever to defend the court below's holding on this point notwithstanding the fact that it was the primary basis on which the court below dismissed the complaint. Nor do appellees make any attempt whatsoever to contest the obvious truth that the rule prohibiting payment of commission based on the service charge constituted a "tampering" with the compensation structures which the member firms could have with

their registered representatives (see plaintiffs-appellants' original brief, pages 27-8). In short, appellees have completely abandoned all efforts to defend the most important part of the holding of the court below in apparent recognition that this holding cannot be legally defended.

Where an appellant's brief on appeal raises a point which goes to the heart of the case and, therefore, is one which it would be expected that the appellee normally would respond to, and no response is forthcoming, then it is reasonable to conclude that the appellee is unable to respond and, rather than conceding the point outright, has chosen to avoid discussing it, thereby conceding it by silence. So it is with appellees' briefs in the instant case. Their failure to make any response to appellants' argument that the rule prohibiting payment of commission based on the service charge was a price fixing scheme, and therefore a *per se* violation of the antitrust laws *absent* some basis for antitrust immunity, can only be interpreted as a concession by them of the correctness of appellants' argument and that the court below has erred on this point.

II. *PER SE* RULES ARE APPLICABLE IN DETERMINING IF THERE IS ANTITRUST LIABILITY ABSENT A BASIS FOR ANTITRUST EXEMPTION

Rather than attempting to defend the lower court's holding that the rule prohibiting payment of commission based on

the service charge was a price fixing scheme, the thrust of appellees' argument on appeal is that _per se_ rules of antitrust liability are not applicable to the securities industry and that liability can be predicted only on an application of the "rule of reason." However, an analysis of the cases on which appellees rely quickly discloses that the argument which they are making is one of semantics only, and not one of substance.

The principle, initially recognized in _Silver v. New York Stock Exchange_, 373 U.S. 341, 83 S. Ct. 355 (1963), that the activities of the securities industry would be exempt from the antitrust laws to the extent necessary to make the Securities Exchange Act work, is itself a form of the "rule of reason" but one which is peculiarly applicable to the securities industry. Appellants do not, and never have, contended that liability could be imposed upon defendants without applying this "rule of reason" test to the conduct in question. However, before this test of antitrust "immunity" is reached, it is first necessary to determine whether the conduct in question would be in violation of the antitrust laws _absent_ a basis for antitrust immunity. It is only with respect to the making of this threshold determination of whether there is a violation of the antitrust laws _absent_ a basis for immunity that appellants contend that _per se_ rules of antitrust liability are applicable.

All the relevant cases, including the cases relied

upon by appellees, support the proposition that per se rules of antitrust liability apply in making this threshold determination. The reference in these cases to the "rule of reason" relates only to whether the conduct in question should be exempt from the antitrust laws as being necessary to make the Securities Exchange Act work, and not to whether the conduct would otherwise be in violation of the antitrust laws absent such exemption.

Perhaps the clearest illustration that per se rules are applicable to the threshold determination of whether there is a violation of the antitrust laws absent a basis for antitrust immunity is the Silver case itself, for there the Court began its opinion by stating that the conduct in question, being the equivalent of a group boycott, would be a per se violation of Section 1 of the Sherman Act absent a justification for it derived from the policy of another statute such as the Securities Exchange Act. Said the Court, 373 U.S. at 348-349, 83 S.Ct. at 1252:

> "It is plain, to begin with, that removal of the wires by collective action of the Exchange and its members would, had it occurred in a context free from other federal regulation, constitute a per se violation of § 1 of the Sherman Act. The concerted action of the Exchange and its members here was, in simple terms, a group boycott depriving petitioners of a valuable business service which they needed in order to compete effectively as broker-dealers in the over-the-counter securities market. . . . Hence, absent any jusitification derived from

> the policy of another statute or otherwise, the Exchange acted in violation of the Sherman Act. In this case, however, the presence of another statutory scheme, that of the Securities Exchange Act of 1934, means that such a conclusion is only the beginning, not the end, of inquiry."

The subsequent language in the Silver decision with reference to the "...aegis of the rule of reason," 373 U.S. at 360, 83 S.Ct. at 1259, heavily relied upon by appellees, refers only to possible justification derived from the purposes and policies of the Securities Exchange Act, and does not mean that per se rules do not apply where justification is absent. In point of fact, the Court in Silver, determined that the conduct there in question could not be justified as being "necessary to make the Securities Exchange Act work" and, therefore, reverted to the threshold determination that there was a per se violation of the Sherman Act and imposed liability on this basis, see 373 U.S. at 365, 83 S. Ct. at 1361.

Similarly, in Gordon v. New York Stock Exchange, 498 F. 2d 1303 (2d Cir. 1974), this Court specifically recognized that the conduct there in question, the setting of minimum commission rates to be charged customers of brokerage firms,would be a per se violation of the antitrust laws unless immune by reason of the powers granted to the Securities Exchange Commission under Section 19(b) of the Securities Exchange Act of 1934, see 498 F. 2d at 1307.

The same is also true of the other cases cited by appellees. None of them hold that per se rules of antitrust liability are inapplicable in determining whether there has been a violation of the antitrust laws absent a basis for exemption. The only difference is that what appellees are referring to as an application of the "rule of reason" test, appellants have been treating under the heading of "antitrust exemption". This difference in terminology obviously is one of semantics only and not one of substance.

So that there will be no doubt, appellants do not suggest that liability can or should be imposed without consideration of whether the conduct in question is necessary to make the Securities Exchange Act work. Appellants do contend that in making the threshold determination of whether the conduct in question would be in violation of the antitrust laws absent a basis for antitrust exemption, per se rules of antitrust liability are applicable. The court below did not hold that per se principles were not applicable in making this threshold determination. Rather, the court below held that a per se violation had not been established (436A). It is this latter holding that appellants have attacked on this appeal and which, as set forth in Point I of this reply brief, appellees have chosen not to defend, apparently because they find themselves

unable to defend it.

In their brief, appellees also make the statement that plaintiffs are arguing that all exchange self-regulation is a per se violation of the antitrust laws absent some basis for exemption (see brief submitted on behalf of all appellees, page 6). No such statement is made anywhere in plaintiffs-appellants' brief, although it should be noted, it would not be inaccurate for plaintiffs-appellants to take this position. As Mr. Justice Stewart stated in his dissenting opinion in Silver v. New York Stock Exchange, supra, on a point on which he was agreeing with, not dissenting from, the majority view that the conduct there in question would be a per se violation of the Sherman Act had it occurred in the ordinary commercial context:

> "It may be assumed, I think, that almost every exercise of an exchange's statutory duty of self-regulation would involve an actual or threatened concerted refusal to deal - a 'group boycott'." See 373 U.S. at 368, 83 S. Ct. at 1262, Footnote 1 (Emphasis supplied).

It is the view of plaintiffs-appellants that all horizontal agreements which are in "restraint of trade," three important words which appellees omit in characterizing appellants' argument as an "extravagant proposition" (see brief submitted on behalf of all appellees, page 6), are per se

violations of the antitrust laws absent some basis for antitrust exemption, because such agreements restrict the ability of competitors to act independently and, therefore, interfere with the free play of market forces, see United States v. Socony Vacuum Oil Co., supra, 310 U. S. at 221-222, 60 S. Ct. at 848. However, it is not necessary for this Court to go that far in determining the instant case. As we have already demonstrated, the rule prohibiting payment of commission based on the service charge was a price fixing scheme and, absent some basis for immunity, constituted horizontal price fixing which clearly is a *per se* violation of the Sherman Act, United States v. Trenton Potteries Co., 273 U.S. 392, 47 S. Ct. 377 (1927), United States v. Socony Vacuum Oil Co., supra. Accordingly, this Court may and should reverse the holding of the court below on this point on this specific basis and need not reach the broader question of whether other types of horizontal agreements would also constitute *per se* violations of the antitrust laws.

III. THE NYSE RULE PROHIBITING PAYMENT OF COMMISSIONS BASED ON THE SERVICE CHARGE IS NOT WITHIN THE REVIEW JURISDICTION OF THE SEC UNDER SECTION 19(b) OF THE ACT AND THEREFORE IS NOT EXEMPT FROM THE ANTITRUST LAWS

Whether characterized as an application of the "rule of reason" or as a principle of antitrust "exemption",

the fact remains that exchange self-regulation is immune from antitrust liability "...only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary", Silver v. New York Stock Exchange, supra, 373 U.S. at 357, 83 S. Ct. at 1257, Gordon v. New York Stock Exchange, supra, 498 F. 2d at 1305. This Court's decision in Gordon came down after the court below rendered its decision in the instant case, and both appellants and appellees appear to be in agreement that the court below's treatment of the immunity question is in error in light of the principles subsequently announced by this Court in Gordon (see brief submitted on behalf of all appellees, page 5).

Interestingly enough, the parties appear to be in basic agreement as to the principles enunciated in Gordon. It is only with respect to the application of these principles to the facts of the instant case that appellants and appellees part company. It is here that the appellees find themselves in a difficult quandry, for the court below found, contrary to appelles' position on appeal, that the antitrust court did have jurisdiction to consider plaintiffs' antitrust claims (423A) and, under the Gordon decision, this holding would necessitate denial of antitrust exemption. On this aspect of the case,

it is really appellees, not appellants, that are seeking reversal of the lower court's determination.

The court below stated the applicable principle to be that where the exchange rule or practice being complained of is within the explicit mandate of the Securities Exchange Act and also is actively reviewed by the SEC, the SEC may and appropriately should itself consider the policies of both the antitrust laws and the securities laws (422A). In such circumstances the antitrust court would be without jurisdiction. However, where the Securities Exchange Act contains no explicit directive to the SEC to supervise the practice or rule, the antitrust court may properly consider it and, in so doing, should evaluate both the policies against restraints of competition and the policies in favor of securing investor protection and fair dealing in securities (422A-423A). This is essentially, although not completely, the analysis adopted by the Seventh Circuit in <u>Thill Securities Corp. v. New York Stock Exchange</u>, 433 F. 2d 264(7th Cir. 1970), <u>cert denied</u>, 401 U. S. 994, 91 S. Ct. 1232 (1971).

In <u>Gordon</u> this court rejected the <u>Thill</u> analysis to the extent that it would permit review by the antitrust court of any matter which could be reviewed by the SEC. The basic difference between the <u>Thill</u> analysis and the <u>Gordon</u>

analysis is that under Thill the antitrust court will consider, in determining whether antitrust exemption should be granted, if there is anything in the Securities Exchange Act regulatory scheme which "performs the antitrust function", see 433 F. 2d at 270, while under Gordon the scope of exchange antitrust exemption is coterminous with the SEC's review and enforcement jurisdiction under Section 19(b) of the Act, 15 U.S.C. §78s(b).* Under Gordon, to the extent that there is SEC jurisdiction under Section 19(b), and judicial review available by appeal from the SEC's determination, the antitrust laws are deemed to be inapplicable. Under Thill the court is required to consider in each case whether the SEC is performing the antitrust function and does not defer to SEC jurisdiction. However, under both approaches, the starting point is the power granted to the SEC under Section 19(b) of the Act as Section 19(b) defines the area of exchange self-regulation which is "necessary to make the Security Exchange Act work." As this Court stated in Gordon, 498 F. 2d at 1306:

> "Congress defined in §19(b) those matters fundamental to achieve the 'aims of the Securities Exchange Act,' Silver v. New York Stock Exchange, 373 U. S. at 361, 83 S. Ct. at 1259, and accorded the SEC the authority to make whatever changes respecting those matters are 'necessary or appropriate' (§19(b)) to effectuate those aims - i.e., in the terms of the Silver test, 'necessary to make the Securities Exchange Act work'. 373 U. S. at 357, 83 S. Ct. at 1257.

*Section 19(b) of the Securities Exchange Act of 1934 is set forth in its entirety in Appendix I to this reply brief.

> "If the discussion in <u>Silver</u> of a core of exchange self-regulation necessary to make the 1934 Act work, and thus immune from application of the antitrust laws, is to be given any meaningful application, <u>we are of the view that it must have reference to the practices enumerated in §19(b)</u> and in this instance to the fixing of reasonable rates of commission." (Emphasis supplied)

Under both <u>Gordon</u> and <u>Thill</u>, if a particular area of exchange self-regulation does not fall within Section 19(b) of the Act it is not exempt from antitrust liability. Under <u>Thill</u>, activity which does fall under Section 19(b) still may not be exempt if the court finds that there is nothing in the regulatory scheme performing the antitrust function and, in this respect, <u>Thill</u> differs from <u>Gordon</u>. However, there is no difference between the two analytical approaches where conduct does <u>not</u> fall within the areas of SEC review under Section 19(b) of the Act. Such conduct is never exempt.

It is precisely with respect to the question of whether the area of exchange self-regulation here involved falls within the SEC's review jurisdiction under Section 19(b) of the Act that the appellants' claim to antitrust exemption disintegrates, for there is nothing in Section 19(b) of the Act which would authorize the SEC to review the NYSE provision which prohibited the paying of commissions based on the service charge. While the service charge itself, Rule 383, is a form of rate fixing, and therefore within the re-

view jurisdiction of the SEC under Section 19(b), Gordon v. New York Stock Exchange, supra, Article XV, Section 9 of the NYSE Constitution, the provision which prohibited payment of commission based on the service charge, is not within any of the areas over which the SEC has review jurisdiction under Section 19(b) of the Act. As the court below found on this point:

> "The service charge itself was a matter over which the Commission possessed and exercised direct regulatory and supervisory authority under 15 U.S.C. §78s(b). The rule concerning compensation to registered representatives, however, fell only partially within the regulatory functions of the Commission. See Merrill, Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117 (1973). The Commission itself, when the registered representatives protested the rule's effect, declined to intervene in matters affecting the relationship between the member firms and their employees, unless the latter could demonstrate a particular need for intervention for the protection of investors. Instead the registered representatives have chosen to attack the rule on the ground that it violates the antitrust laws. In view of the Commission's disclaimer of primary responsibility over that aspect of the rule which the registered representatives here contest, and since the focus of the challenge here is in the sphere of the courts' particular antitrust competence, the Court exercises its concurrent jurisdiction over the controversy." (Emphasis supplied) (423A).

Despite the sometimes loose use of language, the SEC does not "approve" exchange rules. Rather, under Section 6(a) of the Act, 15 U.S.C. §78f(a), an exchange is required to file its constitution and rules and regulations with the SEC. Section 19(b) of the Act then confers a limited power to object to an exchange's

constitution, or to its rules and regulations, in the areas specified in the various subsections of Section 19(b) "for the protection of investors or to insure fair dealing in securities" or to "insure fair administration" of the exchange. See Merrill, Lynch, Pierce, Fenner & Smith v. Ware, 414 U.S. 117, 134-135,94 S. Ct. 383, 391 (1973). Since the SEC's review jurisdiction is limited, it does not follow that, simply because an exchange has submitted a rule or regulation to the SEC and the SEC has taken no action with respect to it, the SEC thereby has "approved" the rule as being necessary "for the protection of investors". Inaction by the SEC may be attributed to the fact that it has no authority to take action against a particular rule because it does not fall within its Section 19(b) jurisdiction. This was the point made by the SEC letter to the Association of Investment Brokers of June 22, 1970, in which Chairman Budge stated that the Commission was declining to take action with respect to the paying of commissions based on the service charge because this was a matter to be determined by the individual firms with their registered representatives, but that "...the Commission stands ready to receive evidence from interested persons which demonstrates, with particularity, that additional regulatory action on our part is necessary or appropriate for the protection of investors" (322A) (Emphasis supplied).

Simply put, since the rule here in question was not related to investor protection, the SEC was without power to do anything about it. The SEC quite properly stated that it would take action if it were deemed necessary "for investor protection", but it could see no relationship between the compensation of registered representatives and investor protection, and, we submit, none exists, see Merrill, Lynch, Pierce, Fenner & Smith v. Ware, supra.

Appellees argue that the SEC was "aware" of the rule prohibiting the payment of commission based on the service charge at the time it approved the service charge (see brief submitted on behalf of all appellees, page 17). From this "awareness" appellees would have the court find that the SEC "approved" of the prohibition*. However, as previously demonstrated, the SEC does not "approve" exchange constitutional provisions and rules and regulations; rather, it can only object to such constitutional provisions, or rules and regulations, to the extent that it has jurisdiction to do so under Section 19(b) of the Act. Therefore, there can be no antitrust exemption unless the SEC had authority

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* With respect to the SEC's assumed "awareness", it should be noted that the SEC specifically state that it was assuming that one-third of the service charge would be paid as commission to the registered representatives when it ran its own tests on it (310A, footnote 3). This fact, which was revealed in one of appellees' own exhibits, in and of itself destroys any possible argument by appellees that the SEC's approval of the imposition of the service charge was in any way related to or dependent upon the member firms not paying commissions to their registered representatives based on it.

under Section 19(b) of the Act to take action against the provision prohibiting payment of commission based on the service charge, see Gordon v. New York Stock Exchange, supra. Appellees have failed to demonstrate where such authority exists under Section 19(b) and, therefore, have failed to establish any basis for antitrust exemption.

IV THE MEMBER FIRM APPELLEES ARE LIABLE UNDER THE ANTITRUST LAWS TO THE SAME EXTENT AS THE NYSE.

In the separate brief filed on behalf of the broker defendants, the argument is made that the member firms should be excused from liability because they acted only in response to the mandate of the NYSE Constitution, and that the rule prohibiting the sharing of the service charge was imposed on the member firm defendants "from above" by the NYSE (separate brief for member firm appellees, page 3, footnote 1). It may be that to the member firm defendants "above" is the New York Stock Exchange. However, we submit that before "above" can justify a violation of the law, it must come from a more lofty pinnacle than the building located at the intersection of Wall and New Streets. The rule which prohibited the payment of commission based on the service charge was part of the New York Stock Exchange Constitution. This Constitution was voted on and approved by the very member firms which are now seeking to defend

their conduct on the basis that they acted in reliance upon it. The Board of Directors of the New York Stock Exchange, which failed to amend Rule 347 to permit the paying of commission based on the service charge, were the elected representatives of these same defendants. Moreover, compliance with this rule was profitable to each of the member firm defendants. Under these circumstances, can it really be said that they acted on the basis of compulsion from above?

It would indeed be a strange principle of law which would permit members of an organization to adopt a rule profitable to themselves and then escape liability under the antitrust laws on the theory that they acted in compliance with that rule. To the extent that the member firm defendants have any defense based on the self-regulatory authority delegated to exchanges by the Securities Exchange Act, such defense exists only to the extent that such self-regulatory activities are exempt from the antitrust laws under Silver v. New York Stock Exchange, supra, and Gordon v. New York Stock Exchange, supra. Their exemption from the application of the antitrust laws is no broader than the exemption of the New York Stock Exchange itself.

The member firms also argue that they are legally bound to follow the Constitution and rules and regulations of the New York Stock Exchange, and that they have no recourse to judic-

ial review should disciplinary proceedings be instituted against them for violating that Constitution or the rules and regulations adopted thereunder. This certainly cannot be, at least while this Court sits. If nothing else, the member firms certainly would have available to them a remedy through an action seeking a declaratory judgment, 28 U.S.C. §2201, if they believed that they were being compelled to comply with an exchange regulation that was in violation of the law. Were such an action to be brought, injunctive relief certainly would be available if appropriate, see Villani v. New York Stock Exchange, 348 F.Supp. 1185 (S.D.N.Y. 1972), affirmed, 489 F.2d 1 (2nd Cir. 1973). One can be certain that if these member firms were affected adversely by a rule or regulation of the New York Stock Exchange, they would have sufficient ingenuity to find an avenue for seeking judicial relief. The argument that the member firm defendants should be excused from liability because they acted in compliance with the Constitution and rules and regulations of the New York Stock Exchange is both legally and morally wrong and should be rejected.

CONCLUSION

For all the foregoing reasons it is respectfully submitted that the decision below should be reversed, that judgment should be entered in favor of the plaintiffs and the

members of the class on the issue of liability, and the case remanded to the District Court for the determination of damages.

Respectfully submitted,

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APPENDIX I

Section 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78s(b):

"(b) The Commission is further authorized, if after making appropriate request in writing to a national securities exchange that such exchange effect on its own behalf specified changes in its rules and practices, and after appropriate notice and opportunity for hearing, the Commission determines that such exchange has not made the changes so requested, and that such changes are necessary or appropriate for the protection of investors or to insure fair dealing in securities traded in upon such exchange or to insure fair administration of such exchange, by rules or regulations or by order to alter or supplement the rules of such exchange (insofar as necessary or appropriate to effect such changes) in respect of such matters as (1) safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility through the use of corporate forms or special partnerships; (2) the limitation or prohibition of the registration or trading in any security within a specified period after the issuance or primary distribution thereof; (3) the listing or striking from listing of any security; (4) hours of trading; (5) the manner, method, and place of soliciting business; (6) fictitious or numbered accounts; (7) the time and method of making settlements, payments, and deliveries and of closing accounts; (8) the reporting of transactions on the exchange and upon tickers maintained by or with the consent of the exchange, including the method of reporting short sales, stopped sales, sales of securities of issuers in default, bankruptcy or receivership, and sales involving other special circumstances; (9) the fixing of reasonable rates of commission, interest, listing, and other charges; (10) minimum units of trading; (11) odd-lot purchases and sales; (12) minimum deposits on margin accounts; and (13) similar matters.

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